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TAX·FEATURES

Typical Two-Earner Family Increased Purchasing Power Since '80

Top 50 Percent of Earners Pay 93.8 Percent of Federal Individual Income Tax Burden; Top Ten Percent Pays Over Half

The top earning half of the population continues to pay well over 90 percent of the Federal individual income tax bill, according to Tax Foundation analysis of preliminary IRS data for 1986. In fact, despite all the major tax legislation of the past decade, this group's share of the tax burden has varied within the narrow range of 92.6 to 94.0 percent of total taxes paid, and was 93.8 percent in 1986.

The system remains progressive as the top ten percent of earners continue to shoulder a significantly larger share of the tax burden, up from 49.5 percent in 1979 to 55.5 percent in 1986, a six percent increase.

This growth in tax burdens has occurred despite the alleged upper-income bias of the rate reductions and other tax cuts under the Economic Recovery Tax Act of 1981 (ERTA). The Treasury Department reported that for the 1981-1986 period taxpayers with adjusted gross incomes exceeding $100,000 paid $72 billion more in 1986 than in 1981 while persons with adjusted gross incomes under $50,000 received a net tax cut of $18 billion between 1981 and 1986.

Growth in the income base itself has been increasing faster at the upper end of the income scale, resulting in increased tax receipts from top earners. Specifically, the increase in capital gains taxes accounted for the bulk of the tax revenue rise in 1986. The jump in the top tax rate on capital gains from 20 percent to 28 percent beginning January 1, 1987 under the Tax Reform Act of 1986 caused an extraordinary level of capital gains realization before the increase kicked in. Taxable net gains in 1986 rose 99.6 percent to $135 billion, accounting for 25 percent of income to earners in the top income brackets and fueling a 9.4 percent jump in total adjusted gross income to $2.52 trillion.

In 1986, the top five percent of earners paid an average tax of $31,309, up 80 percent from 1979. The

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Increased earnings, slower inflation and Federal individual tax cuts have boosted the U.S. family's purchasing power since 1980, according to Tax Foundation analysis. Since approximately 60 percent of married-couple families now include a wife in the paid labor force, the Tax Foundation has replaced the one-earner family analysis with the more realistic two-earner household. A typical family—a household with two earners employed full-time, year-round with two dependent children—realized an increase in real income of $3,714 since 1980 after adjusting for direct Federal taxes.

The two-earner median family's nominal income has risen consistently since 1980, averaging approximately a six percent increase each year. The two-earner family making $29,627 in 1980 is now making an estimated $46,848. However, when direct Federal taxes and inflation are taken into account, the $17,221 increase in this family's income between 1980 and 1988 resulted in only a $3,714 net gain. Over 78 percent of increased income has been eroded by direct

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Median Family Income Before and After Direct Federal Taxes and Inflation
1980-1988

Year	Two-Earner Median Family Income[a]	Direct Federal Taxes: Income Tax[b]	Direct Federal Taxes: Social Security	Direct Federal Taxes: Total	After-Tax Income: Current Dollars	After-Tax Income: 1988 Dollars[c]
1980	$29,627	$4,050	$1,816	$5,866	$23,761	$33,993
1981	32,224	4,386	2,143	6,529	25,695	33,327
1982	34,515	4,450	2,313	6,763	27,752	33,927
1983	36,106	4,300	2,419	6,719	29,387	34,778
1984	38,713	4,634	2,710	7,344	31,369	35,606
1985	40,593	4,787	2,862	7,649	32,944	36,083
1986	42,492	5,158	3,038	8,196	34,296	36,877
1987[d]	44,617	5,319	3,190	8,509	36,108	37,456
1988[d]	46,848	5,623	3,518	9,141	37,707	37,707

[a] Median income for household with two earners employed full-time, year round.
[b] Married couple filing joint return, two dependent children.
[c] Adjusted by Consumer Price Index, assumes 3.8% inflation in 1988.
[d] Estimated by Tax Foundation.

Source: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics; Treasury Department, Internal Revenue Service.

Federal Grants Drop 4.5%; FL, TX Pay Highest Aid Premiums

Federal grants-in-aid to state and local governments dropped 4.5 percent in FY87 (latest available) to $102.9 billion, according to Tax Foundation economists. This was their first decline since 1982. They had been averaging six percent increases over the last four years. With FY87's 4.5 percent decline, the pace of Federal grant giving has continued its sharp slowdown since 1981. After growing at annual rates averaging 15 percent during the 1970s, growth in Federal grants has averaged 2.3 percent since 1980.

Federal Grants-In-Aid To State and Local Governments and Estimated Federal Tax Burden for Grants

Fiscal Year 1987

State	Grants[a] ($Millions)	Percent of Total Tax Burden	Tax Burden per Dollar of Aid	Estimated Tax Burden for Grants[b] ($Millions) Amount	Rank
Total	$102,934.5	100.00%	$102,934.5	$1.00	-
Alabama	1,510.3	1.23	1,266.1	.84	32
Alaska	605.4	.29	298.5	.49	50
Arizona	1,172.7	1.23	1,266.1	1.08	12
Arkansas	1,000.8	.68	700.0	.70	38
California	10,909.9	12.59	12,959.5	1.19	10
Colorado	1,105.7	1.36	1,399.9	1.27	6
Connecticut	1,489.0	1.97	2,027.6	1.36	4
Delaware	301.4	.30	308.8	1.02	17
Florida	3,151.0	4.91	5,054.1	1.60	1
Georgia	2,507.2	2.26	2,326.3	.93	27
Hawaii	459.7	.42	432.3	.94	25
Idaho	372.0	.30	308.8	.83	33
Illinois	4,466.8	5.28	5,434.9	1.22	8
Indiana	1,981.6	2.00	2,058.7	1.04	14
Iowa	1,089.6	.99	1,019.1	.94	26
Kansas	845.8	1.00	1,029.3	1.22	7
Kentucky	1,687.0	1.10	1,132.3	.67	41
Louisiana	1,914.1	1.39	1,430.8	.75	37
Maine	688.8	.39	401.4	.58	45
Maryland	2,254.1	2.21	2,274.9	1.01	18
Massachusetts	2,983.3	2.99	3,077.7	1.03	15
Michigan	4,196.2	3.97	4,086.5	.97	21
Minnesota	2,034.9	1.74	1,791.1	.88	29
Mississippi	1,253.3	.64	658.8	.53	48
Missouri	1,923.0	1.96	2,017.5	1.05	13
Montana	496.4	.26	267.6	.54	47
Nebraska	606.2	.57	586.7	.97	22
Nevada	382.2	.43	442.6	1.16	11
New Hampshire	388.1	.49	504.4	1.30	8
New Jersey	3,326.9	4.44	4,570.3	1.37	3
New Mexico	690.8	.46	473.5	.69	39
New York	11,932.0	8.75	9,006.8	.75	36
North Carolina	2,168.3	2.16	2,223.4	1.03	16
North Dakota	404.8	.23	236.7	.58	44
Ohio	4,381.3	4.25	4,374.7	1.00	19
Oklahoma	1,313.2	1.15	1,183.7	.90	28
Oregon	1,032.8	.97	998.5	.97	23
Pennsylvania	5,267.6	4.82	4,961.4	.94	24
Rhode Island	549.9	.41	422.0	.77	35
South Carolina	1,276.7	1.02	1,049.9	.82	34
South Dakota	436.0	.21	216.2	.50	49
Tennessee	1,890.8	1.60	1,647.0	.87	30
Texas	4,846.4	6.65	6,845.1	1.41	2
Utah	748.6	.47	483.8	.65	42
Vermont	313.5	.19	195.6	.62	43
Virginia	2,143.6	2.48	2,552.8	1.19	9
Washington	1,944.5	1.88	1,935.2	1.00	20
West Virginia	1,026.3	.54	555.8	.54	46
Wisconsin	2,154.2	1.82	1,873.4	.87	31
Wyoming	287.7	.19	195.6	.68	40
District of Columbia	1,024.4	.36	370.6	.36	51

[a] Excludes shared revenues and payments in lieu of taxes; includes general revenue sharing and trust fund aid.
[b] The tax burden for grants is assumed to equal grant payments.
Source: Tax Foundation computations based on data from the Treasury Department and U.S. Department of Commerce, Bureau of the Census.

The Big Four

Twenty-five programs account for more than 85 percent of total grant disbursement. Of these, the largest four are medicaid - $27.2 billion, highways - $11.2 billion, Aid to Families with Dependent Children (A.F.D.C.) - $10.5 billion, and housing assistance at $5.8 billion. These four programs alone accounted for over 53 percent of all grants disbursed in fiscal 1987. While highway assistance was reduced sharply by 14.8 percent from FY86 to FY87, A.F.D.C. and housing assistance showed sizeable increases of 12.6 percent and 9.7 percent respectively. In 1987 there were approximately 372 different grant-in-aid programs, but most of the spending was concentrated in a few areas.

Most of FY87s $4.9 billion reduction in Federal grants was the result of elimination or consolidation of smaller programs where the benefits were primarily local rather than national, such as economic development and the construction and operation of local transportation systems.

Winners and Losers

Tax Foundation analysis of the grant-in-aid programs determines where Federal grant revenue is raised and where it is disbursed on a state-by-state basis. In terms of their Federal

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Tax Features

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Budget Watch By Allen Schick

Tax Expenditures: Myths and Realities

Tax expenditures are among the most controversial and confusing features of the Federal budget. The concept appears to be simple; applying it to the numerous provisions in the tax code is not. The term refers to deviations from the "normal" tax structure that give preferential treatment to particular activities or groups of activities and result in a loss of Federal revenues. The term recognizes that these preferences have the same subsidy effects as direct expenditures: they provide financial benefits to recipients and they cost the Treasury money. Tax expenditures were officially defined in the Congressional Budget Act of 1974. Before then, they were called loopholes; they still are.

The tax code is complex and the concept is often used for political advantage; hence, there are serious misunderstandings about tax expenditures. This article examines four myths about tax expenditures; (1) it is just as easy to define and measure them as direct spending; (2) most tax expenditures go to business; (3) among individuals, high income persons are the main beneficiaries; and (4) the steady rise in the amount of tax expenditures is due to recent legislation establishing new loopholes. None of these claims is warranted by the facts.

Myth No. 1

It is easy to define and measure tax expenditures.

The definition of tax expenditures is inherently ambiguous. A provision of the tax code deemed to be a preference by some experts might be regarded as an essential feature of the tax system by others. The list of tax expenditures published by Congress' Joint Committee on Taxation (JCT) in March 1988 contains 28 items not included in the analysis issued only one month earlier by the President's Office of Management and Budget (OMB).

Some of the confusion results from applying a double standard to tax expenditures. The tax code has provisions which are virtually identical, but some are regarded as part of the normal rate structure while others are labelled as preferences. The tax rates

Before the Budget Act of 1974, tax expenditures were called loopholes; they still are.

levied on corporate and individual incomes are a case in point. With the implementation of the Tax Reform Act of 1986 (TRA'86), both types of income now have a two-rate structure. Individual income is taxed at 15 percent and 28 percent; corporations pay a reduced rate on the first $75,000 of income, and 34 percent on income above that amount. One can argue either that differential rates are a normal feature of a graduated tax structure or that they provide a preference for low-income persons and firms. However, Congress' tax mavens have decided to treat the lower individual and corporate rates differently. They list the lower corporate rate as a tax expenditure, but treat the lower individual rate as part of the tax structure. This double standard demonstrates how the measurement of tax expenditures is colored by subjectivity.

By no means is this the only dubious application of the tax expenditure concept. A brand new one has just entered the official list, thanks to the TRA'86 limitation on the extent to which passive losses can be used to offset other income and thereby lower an investor's tax liability. The concept of a normal tax structure is that all income should be treated alike for purposes of taxation. It would seem that just as a tax structure has some preferences which are classified as tax expenditures, it might also treat some income less favorably, and these instances might be regarded as "negative tax expenditures" because they increase tax liabilities and Federal revenues above normal levels. This situation would seem to apply to taxpayers who have passive losses. Some passive losses (for example, for rehabilitation of structures and low-income housing) are exempted from the special tax rules. As a result, income from these sources is taxed at the normal level. But the JCT tax experts have decided that these exemptions constitute tax expenditures, despite the fact that taxpayers pay the same taxes as they would on active income. This convoluted logic isn't fair, doesn't make sense, and demonstrates the difficulty of defining and measuring tax expenditures.

Myth No. 2

Business gets most tax breaks.

Judging from the newspapers, it would appear that the biggest loopholes benefit big business. The facts prove otherwise, but myths often per-

The list of tax expenditures published by Congress' Joint Committee on Taxation (JCT) in March 1988 contains 28 items not included in the analysis issued only one month earlier by the President's Office of Management and Budget (OMB).

sist in the face of facts to the contrary.

The official list of tax expenditures distinguishes between those benefit-

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(BUDGET WATCH, *from page 3*)

ting corporations and those provided to individual taxpayers. For various reasons, it is not correct to add up all tax expenditures as if they were independent from one another. Tax expenditures interact with one another and with other provisions of the tax code, so that the total can be either greater or less than the sum of individual preferences. Nevertheless, adding up tax expenditures shows the enormous disparity between the value of the preferences going to individuals and corporations.

JCT estimates that tax expenditures will approach $300 billion in the 1989 fiscal year. But only 12 percent of these benefits, or $37 billion, are provided to corporations; approximately $160 billion goes to individuals. OMB, which has a narrower definition of tax expenditures, reports even fewer preferences going to corporations.

Myth No. 3

Wealthy persons get most tax expenditures.

It is widely taken for granted that most tax breaks go to upper-income persons. In fact, however, the overall bulk of the individual tax breaks go to the middle class. The following five preferences account for more than half of all the tax expenditures projected to benefit individuals in fiscal 1989:

These exemptions and deductions

Preference	Billions of Dollars
Exclusion of pension contributions and earnings	$45.6
Deduction of mortgage interest on homes	30.8
Exclusion of employer payments for medical insurance and care	27.6
Deduction of state-local property and income taxes	24.5
Exclusion of social security benefits	18.0

are costly and popular because they benefit many millions of Americans. With the exception of social security payments and medicare, they are the biggest middle class subsidies in the Federal budget.

There is a significant relationship between wealth and income on the one hand and tax expenditures on the other. Tax expenditures are a function of tax liability. The higher a person's tax bracket, the greater the value of the tax preferences that he or she is likely to receive. The millions of persons removed from the tax rolls by TRA'86 have no tax expenditures (except for those who receive the earned income credit) because they do not pay any taxes. Conversely, those who have had high tax liabilities generally also have had high tax expenditures through itemized deductions and other provisions.

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However, by reducing marginal tax rates, TRA'86 significantly reduced the value of major tax expenditures for all income groups. According to CBO estimates, the dollar value of the five tax expenditures listed above will be more than $40 billion lower in 1991 than it would have been if marginal tax rates had not been changed by the 1986 law. Both before and after TRA'86 the distribution of tax expenditures has been roughly proportional to taxes paid. A $150,000 income earner is likely to pay substantially more income taxes and at the same time enjoy more tax expenditures than the more typical $35,000 income earner. But because there are so many more of the latter, the overall dollar value of individual tax expenditures is concentrated among the middle-income groups.

Myth No. 4

Tax expenditures have been rising because Congress has enacted new preferences.

The value of tax expenditures has steadily increased over the dozen or so years that comparable data have been available. The usual explanation is that Congress has established new tax expenditures. The real reason is that as tax burdens have escalated, the value of old tax expenditures has also increased. The table below classifies fiscal 1989 tax expenditures by the period in which they were first enacted or recognized by the IRS or other authorities. The list is not complete because the date of origin of a few tax expenditures has not been determined. The pattern, however, is remarkable. Legislation enacted since 1960 accounts for only a small portion of tax preferences. The largest amounts derive from legislation enacted (or rulings issued) about the time the income tax was introduced. Other major expansions occurred during the World War II period when tax rates were substantially increased.

. . . the overall bulk of the individual tax breaks go to the middle class. . . . These exemptions and deductions are costly and popular because they benefit many millions of Americans.

Period During Which Tax Expenditure Was First Enacted or Authorized by Regulation	Estimated Fiscal Year 1989 Value ($billions)
1920 or Earlier	$102
1921 – 1940	56
1941 – 1960	94
1961 – 1980	21
Since 1980	4

To sum up, high tax expenditures are associated with high tax burdens. The best way to significantly lower tax preferences is to reduce rates and liabilities. This isn't myth; it's a fact.

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FEDERAL TAX POLICY MEMO

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The Future of Social Security Financing

Summary

(I) The old age and disability trust funds currently are building large surpluses. However, the social insurance system as a whole, including the hospital insurance component, could experience operating deficits by the turn of the century, only eleven years ahead. Without reforms, deficits are likely to become large by 2020 and overwhelming by mid-century.

(II) Political opposition to changes in the benefit structure and financing of social security is strong but not totally unyielding. Changes that would put the system on a sound financial footing and target the transfer or welfare element more effectively can be made gradually without destroying support for the system. These changes should encourage middle- and upper-income retirees/beneficiaries to rely more on private sector arrangements but preserve the payroll tax-financed basic system for all workers.

(III) To ease the Federal deficit problem now, inflation indexing of social security benefits could be limited to that increase in the consumer price index above a 2 percent floor. This restraint should be applied for a period of 5 years to the personal tax structure as well as to social security and other entitlement programs.

(IV) For the longer term, consideration should be given to a two-tier benefit structure: the first tier assuring a minimum level of support for low- and modest-income retirees financed by general revenues; and the second tier as an annuity program for all workers based solely on payroll tax contributions. Public subsidy would be limited to the first tier.

(V) Consideration should be given to changing the tax treatment of paid OASI taxes against income taxes and raising this percentage later on. OASI benefits could be subject to full income taxation after retirees recover the cost of their nondeductible OASI contributions.

Background

In 1988, the Social Security payroll tax rate jumped 36 basis points to 7.51 percent for each employee and employer. The maximum tax for employees moves up 8 percent or $248 from 1987 to $3,380. The maximum tax on the self-employed will be a hefty $5,859, up 9 percent or $472 from 1987.

In overall dollars, the 1988 social security payroll boost will amount to $16.6 billion, most all drained from the private sector. Little wonder that most all moderate- and many middle-income families pay more in social security taxes than they do in Federal income taxes. The same is true for millions of employers in labor intensive industries.

Despite the increasing burden of payroll taxes, the concern over the growth of entitlements generally, and serious threats to the long-term health of the system, it has proven extremely difficult to implement any restraint on benefits or structural changes in social security. For example, last fall the budget summit participants gingerly raised again the possibility of a slight cutback in the inflation indexing of social security benefits. Even a small adjustment here could have had a quite significant effect on budget outlays. But as soon as the word got out that the summit was even talking about such a move, the opposition quickly rose to the occasion. In fact, there wasn't even any need for a letter-writing campaign. Just the appearance on the evening news of Congressman Claude Pepper—a spokesman for millions of social security beneficiaries and a stout defender of the system—was enough to send everyone scuttling away from any changes.

This paper will look more closely at several aspects of social security financing:

(1) Short-term outlook and the relationship to the overall budget problem.

(2) The long-term imbalance and proposals to deal with it.

(3) Tax policy choices with respect to both (1) and (2).

Going Into The 1990s

The old age, survivors and disability (OASDI) trust funds right now are beginning to build substantial surpluses, proba-

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bly averaging well over $50 billion per year for the next five years. Reasons for this are twofold:

(1) *Temporarily* there are more favorable demographic factors. There is a bulge in the employed work force paying taxes now as a result of the postwar baby boom, and there will be a relative dearth of retirees in the 1900-2000 period as a result of the baby bust during the Great Depression.

(2) The 1983 amendments raised payroll taxes substantially. It's important to note, however, that the *acceleration* of these taxes, both in terms of rate and base, is now over. We are back on the track of the pre-1983 amendments, albeit at a higher level. Under current law, only one more small rate increase is scheduled (in 1990), and there will be only "normal" expansion of the wage base in line with average wage levels.

In any event, the numbers have tempted some to claim there is no real problem with social security except, perhaps, that payroll taxes are too high. And, as social security is running such surpluses, it doesn't seem to have much to do with the Federal budget deficit. So why worry?

One reason is medicare. Despite efforts under budget reconciliation to reduce hospitalization costs, the hospital insurance (HI) fund is in far worse shape than OASDI. In fact, under the middle-range economic projections of the Social Security Trustees, the HI fund will be in deficit by 1998, and the assets exhausted six years later. Under the "pessimistic" projection, which may be the most realistic, the deficit date moves up to 1994 and funds would be totally depleted in 1999. The financing situation gets progressively worse in future years regardless of which economic assumptions are used.

For policy purposes it is often argued that medicare, both hospitalization (part A) and medical expense (part B), should be kept separate from the retirement and disability system. But the political pressure "to pay" for any future HI fund deficiencies with OASDI surpluses will be enormous. The funds have been comingled in the past and this is clearly the path of least resistance compared to future payroll tax rate or base increases.

At this point, we should take note of the new catastrophic care legislation. This *may or may not* affect the HI trust fund on a net basis. Although most of the additional costs under the legislation involve expanded hospital benefits, these costs supposedly would be financed entirely by increased premiums paid by medicare recipients and periodically transferred to the HI fund. Most of the premium increase would be related to income of eligible recipients and would rise in future years in accordance with medicare cost experience. Theoretically, therefore, the HI fund would not be further depleted even if costs exceed projections, which, given the history of medicare, would hardly be surprising. Whether Congress will acquiesce in continued sharp increases in these premiums—really progressive income taxes—on approximately 40 percent of the elderly is another matter. Catastrophic care provisions could easily accelerate and deepen the medicare financing problem.

Table I

Estimated OASDI and HI Income and Outgo By Alternative Assumptions Selected Calendar Years 1988-2060

($Billions)

	Alternative II-B			Average of II-B and III[a]		
Year	Income	Outgo	Surplus or Deficit(-)	Income	Outgo	Surplus or Deficit(-)
1988	$317.1	$276.7	$40.4	$315.1	$277.0	$38.1
1989	335.8	294.8	41.0	331.1	296.5	34.6
1990	363.5	317.9	45.6	359.7	322.3	37.4
1991	387.2	340.9	46.3	384.3	349.4	35.0
1992	413.3	364.4	48.9	406.2	376.8	29.5
1993	440.8	388.8	52.0	435.2	404.7	30.6
1994	469.6	414.5	55.1	465.9	434.6	31.3
1995	499.5	441.5	58.0	497.9	466.1	31.8
2000	678.4	600.9	77.5	684.1	653.6	30.5
2005	915.4	817.6	97.8	931.8	915.4	16.4
2010	1,221.3	1,145.1	76.2	1,254.7	1,320.8	-66.2
2015	1,609.4	1,662.4	-53.0	1,666.7	1,975.4	-308.7
2020	2,101.3	2,448.4	-347.1	2,190.6	2,992.8	-802.3
2025	2,736.3	3,540.6	-804.3	2,866.5	4,448.6	-1,582.1
2030	3,569.5	4,949.4	-1,379.9	3,751.0	6,376.9	-2,625.9
2035	4,663.0	6,675.7	-2,012.7	4,910.4	8,777.4	-3,867.0
2040	6,077.6	8,765.6	-2,688.0	6,407.6	11,707.5	-5,299.8
2045	7,904.4	11,448.3	-3,543.9	8,332.4	15,479.9	-7,147.5
2050	10,274.5	15,036.1	-4,761.6	10,816.8	20,525.7	-9,708.9
2055	13,369.6	19,805.5	-6,435.9	14,046.9	27,237.9	-13,191.1
2060	17,417.6	26,022.2	-8,604.6	18,258.7	36,000.9	-17,742.3

[a] Not an official projection of the Social Security Trustees.
Source: 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

Shaky Projections

Given the problems of medicare, it makes sense to look at the *overall* social insurance financing picture combining OASDI and HI funds. This is done in Table I for two sets of alternative economic and demographic assumptions from 1988 on into the twenty-first century. Traditionally, most analysts focused on the middle range assumptions of the Social Security Trustees, specifically their II-B set of assumptions as shown in the table. More recently, however, the most pessimistic case—the Trustees' alternative III—is getting more attention and is said to be more realistic at least for the next decade. It's the only one assuming any recession in the 1990s. Alternative III may be too pessimistic particularly with respect to real wage increases, and for our purposes it makes sense to average the results of official projections II-B and III. This also is shown in the table.

If the averaging of II-B and III represents the most prudent look ahead, the combined OASDIHI funds would stay in surplus until after 2005; but the margin of income over

expense would not be that large compared to the size of the program. Given all the variables in this exercise it could as easily be negative by the turn of the century. And almost regardless of economic assumptions used, the long-term picture after 2020 is one of overwhelming deficits.

Budget Relationship

When the unified budget was adopted in the late 1960s, Federal trust funds, such as for social security and highway construction, became part of the official budget submitted to Congress every year. Analysts noted that the operation of these large funds had important implications for the credit markets and the economy. Therefore, they should be included in the overall budget plan. Although such funds were not subject to the regular appropriation process on an annual basis, Congress had the power to change the authorizing legislation and to influence the level of spending and/or taxation any time it chose to.

In the last two decades, entitlement programs, especially social security and medicare, have grown like topsy and have begun to overshadow the rest of the Federal budget. By FY 1987, social insurance payroll taxes were at $303 billion, or 35 percent of total budget receipts. Social security and medicare outlays (including part B of medicare financed by individual premiums) amounted to $284 billion, 28 percent total budget outlays, and 56 percent of total outlays excluding defense and interest costs. A legend began to build that a very large part of the Federal government was beyond control of the budget process. Budget reports began to separate government spending by the classification "relatively uncontrollable"—meaning social security benefits and interest in particular—and the remainder which supposedly Congress had better control over.

There is some truth in the notion of "relatively uncontrollable costs." Interest must be paid regardless of policy preference. And, as we have seen, it is very difficult to make changes in social security benefits on an annual review basis. The very description of social security as an *entitlement* program, whereby benefits are provided automatically to the qualifying population according to pre-set eligibility standards, indicates the strength of political commitment.

Partly because of the entitlement nature of social security benefits, many of the system's supporters have never accepted its inclusion in the unified budget. More recently they worried about the growing Federal deficit and the temptation to attack it through retrenchment of social security (so far much more of a temptation than a reality). Presumably, a social security system taken off the budget would be a less likely target for deficit reduction purposes.

To this concern was added another on general fiscal control. To the extent that the OASDI funds are in surplus now, they are helping to finance the deficit. In fact, without the OASDI surplus, the deficit would be $40 billion higher right now. According to Senator John Heinz (R-PA), removing social security from the budget should open the door for an effective across-the-board freeze on other spending.

These concerns appeared to carry the day in the 1983 social security amendments when Congress agreed to move the trust fund off-budget by FY 1993, later advanced to FY 1986.

Officially that is where the matter rests. Social Security is off-budget for purposes of drawing up the budget. However, in the critical Gramm-Rudman-Hollings procedure, it is promptly put back in for purposes of determining the size of receipts, outlays and the deficit reduction targets. Thus, those who would isolate social security from short-term budgetary pressures have not totally succeeded. Nor is it likely they will as long as social security remains a non-funded operation.

No Real Reserve

It is often said that the build-up of social security assets will be needed to finance the retirement of the babyboomers after 2020 without sending payroll taxes to sky-high levels. This is given as another reason for separating social security from regular budget concerns and keeping the assets intact. It would make a much better argument if there really was a social security reserve building up to take care of future retirees, similar to the operation of private sector and state/local government pension plans.

It doesn't work that way. The social security system holds paper promises from the Treasury to make good on those assets which are "invested" in government securities. The money from the current account surpluses actually is being used to support other government programs and allows the Federal government to borrow less from the private sector than it otherwise would have to do. When it comes time to draw down on social security assets to meet the benefit schedule in the next century, there will be no segregated "funds" available in the reserve. There will simply be the Treasury and its promise to pay, presumably backed by the taxpayers. Under the existing arrangement the only way for real resources to be set aside for future consumption (retirement and disability benefits) would be for the Federal government to run a surplus overall instead of a relatively small surplus in an agency account far outweighed by the deficit elsewhere. That is not about to happen for the foreseeable future.

Like it or not, we are faced with three general "givens" about social security financing.

- The system is not really creating reserve, but it cannot be described accurately as "pay as you go" either. The latter connotes a balance or near balance of income and outgo on a regular basis. It is instead a long-wave revolving fund that currently helps finance general government with a surplus of payroll taxes over expenses and which eventually will call on general government to redeem these excess contributions.
- Whether we designate social security on- or off-budget makes no real difference to the economy itself right now. In the near term, the overall effect on the econ-

omy must be assessed in terms of the total cash flow between public and private sectors. The nominal budget deficit may be higher or lower depending on how the trust funds are treated, but the government's borrowing needs from the public will not change. An extra dollar in social security taxes or reduced benefits will be a dollar not needed to be raised in the credit markets, and whether or not social security financing had any role in *causing* the current budget deficit does not change the basic relationship.

- By the same token, how we describe social insurance in terms of the budget may have a decided impact on political decisions as to the size and direction of the program as well as efforts to control the size of government in general.

Fairness

For retirees first eligible in 1987 the average monthly OASI benefit was $745 for couples, and roughly two thirds of that for single individuals or surviving spouses. Clearly such benefits are not going to support a frivolous life style. However, past increases in benefits have been sufficient to help raise significant numbers of the elderly above the poverty level. If there are large cutbacks in benefits, critics charge that many of the elderly will be pushed back below the poverty level.

What if there were no actual cutbacks in current dollar benefits, just a slowing in benefit increases? This is what many proposals for retrenchment would do. A commonly offered one is the CPI-minus-two approach to limit the inflation indexing of both entitlement expenditure programs and the individual income tax structure to that increase in the consumer price index *above* a two percent floor. As long as the reported national inflation rate stays above two percent, which is a very likely scenario, the CPI-minus-two proposal would result in substantial budget savings—approximately $68 billion—during the period 1989-1993 for social security and railroad retirement programs alone. Applying the same adjustment to indexing of income taxes would yield somewhat less but still substantial budget savings in the form of revenue increases.

Proponents of the CPI-minus-two measure claim it would be a fair way to split the burden of deficit reduction without concentrating it unduly on any one sector and without making any *current* dollar reduction in benefits received. Moreover, if inflation heats up, program beneficiaries and taxpayers would still be protected from all but a small part of the reported inflation rate.

Every time such a proposal hits the press it immediately gets tagged as a "benefit cut" rather than a reduction in the rate of increase. Of course, there would be some cut in *real* benefits if the reported inflation rate accurately represented changes in the economic well-being of consumers. Over time the cumulative loss in real benefits, so defined, could be significant and it would have an impact on benefit recipients at all income levels.

No price indexing can capture fully the substitution effect of price changes on buying habits. In periods of high inflation, higher than 5 percent annually, the substitution effect of selecting less expensive—though not necessarily less useful—grades of products and services becomes marked. But it is not practical to change the weighting of the index frequently enough to reflect this on a regular basis. Therefore, a number of analysts believe the CPI has a persistent upward bias. In times of relatively modest inflation, this upward bias is undoubtedly less than 2 percent annually. During high inflation, it would run over 2 percent. Over the long run, it could average out to about 1 to 1 1/2 percent per year. Thus, the application of a 2 percent threshold on the indexing adjustment might well result in only slight erosion of real benefits after further adjustment for the substitution effect.

Replacement Rates

A traditional method of measuring the adequacy of social security benefits is the extent to which they "replace" earnings just before retirement. As a result of benefit liberalization, particularly in the early 1970s, replacement rates rose sharply in the 1970s through 1981. Since then replacement rates have leveled off in the case of low earners and declined among workers with average earnings. The earlier double indexing of benefits had induced an abnormal bulge in replacement rates from the late 1970s through 1981. This factor was removed (decoupled) under the 1977 amendments with a delayed impact.

Still, replacement rates for both low earners and average earners are at historically high levels. For average-earning workers, they are running at 41 percent, 10 percentage points above the 1960s; among low earners, at 66 percent, about 25 percentage points above the 1960s. Furthermore, because they are based on the most recent earnings, social security replacement rates understate the relationship of benefits to earnings over a life cycle. If adjustments are made for this and other factors such as different tax treatment and the absence of child rearing expense, relative replacement rates would be much higher. Michael Boskin estimates such replacement rates for middle-income retirees at two-thirds previous earnings, and four fifths for modest income retirees.[1]

High replacement rates at the low end of earnings do reflect a deliberate setting of a "progressive" benefit structure. But overall it was never intended that social security should be the *major* source of retirement income. Private savings and pensions were to provide the bulk of support with social security fulfilling only the base need. Replacement rates over 50 percent for average earners certainly were not part of the original concept. There is evidence, in fact, that the growth in benefits and spread of the system to cover over 90 percent of the work force has displaced private savings for retirement and may be a contributing factor to the long-term decline in the personal savings rate.

Rates of return on social security—that is benefits re-

[1] Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security* (The Twentieth Century Fund, 1986).

ceived in relation to past payroll taxes paid—are still extremely generous. Current retirees at age 65, who were at the maximum creditable wage all along, recover the dollar amounts of their own contributions in less than 2 years. Low-wage earners recover their tax contributions in an even shorter time.

Means Testing and Current Tax Policy

"Means testing" is a loaded expression. Those using it tend to shy away from saying exactly what they mean. It could be subjecting social security beneficiaries to a higher dose of income taxation. Or it could be a cutoff of benefits to those above some arbitrary income line. After "contributing" $3,000-$4,000 a year for some time in payroll taxes, how do you think middle America reacts to the latter?

Of course, a welfare element in social security through the higher replacement rates for low-income earners and a large transfer element to all retirees from the current work force have long been recognized. But system supporters have resisted stoutly attempts to isolate part of social security as income maintenance and apply income-based restrictions on benefits to middle- and upper-income retirees. The theory is that only if the system provides benefits across the board will it retain broad political support to redistribute income to the elderly poor or near poor. Strictly as a welfare program the potential cost of social security could be shrunk dramatically, but so, too, would its appeal to middle America.

This theory is backed by the tax/benefit structure of the current system. The payroll tax base supporting the system rises automatically with average wage levels and occasionally above that on an ad hoc basis such as under the 1983 amendments. In any case, *future benefit levels* are tied directly to covered wages. The sting of higher payroll taxes is softened in part at least by the promise of more benefits at retirement.

In the case of medicare the payroll tax/benefit connection has been more tenuous. In last year's budget reconciliation battle there was an attempt to break the connection for upper-income groups by eliminating the wage cap on the HI payroll tax base and using the proceeds, estimated at over $6 billion in the first full year, for deficit reduction completely unrelated to medicare benefits. The attempt failed, but it could come up again. In the meantime, catastrophic care legislation will weaken the link between payroll taxes and medical benefits by forcing the elderly to finance more of their benefits with income-related premium increases.

At this juncture, it's still hard to see any serious move to disassociate benefits of the basic old age and disability program from payroll tax contributions. *Direct* means testing of benefits seems unlikely.

Income taxation of benefits could be considered an *indirect* means testing. Currently, retirees with income of over $32,000 (joint return) and $25,000 (single) are subject to income taxation on half their social security benefits. Receipts from this source are transferred to the OASDI trust funds. Now, that amounts to only about $4 billion, less than 2 percent of the total income flow. Under current law, however, this proportion will rise quite sharply in the years ahead because the income tax thresholds are not indexed. More and more retirees will find themselves subject to income taxation on benefits even if only modest inflation continues.

Proposals have been made to extend the income tax to more than half of benefits received with the existing or lower thresholds, on the grounds that past contributions of retirees have "paid" for only a very small part of benefits received. Former Speaker of the House, Tip O'Neill, suggested subjecting 85 percent of benefits to tax.

Clearly there are some important policy and equity considerations here. Until 1983, social security benefits were exempt from any income tax. There was never a deliberate legislative or broad policy determination to forego tax. It descended from court decisions and administrative rulings holding that social security benefits were akin to "gratuities" for which no service had been rendered.

Most analysts felt that these were pretty shaky grounds. No challenge developed until recently because of the prevailing view that the elderly, along with the disabled and unemployed, were a dependent group and deserving of tax forgiveness. That view is changing with respect to both unemployment compensation and OASDI benefits. But a move to tax as much as 85 percent of benefits is a very large leap. Even if such a high level could be justified by actual rates of return currently, these rates will be declining in the future and 85 percent coverage would lead increasingly to double taxation.

A case can be made that social security benefits should be treated similarly to contributory pensions. Under current law, such pension recipients are subject to income taxation of their benefits but also are allowed to exclude the cost of their own after-tax contributions according to a formula based on life expectancy. If the retiree dies before his or her cost is recovered, the basis is passed on to heirs or beneficiaries. This latter element would be very difficult to graft onto a public income transfer program. Alternatively, retirees could be allowed to recover their own social security contributions first, deferring imposition of income tax accordingly. This would be akin to the former three-year rule on contributory pensions. The Treasury would lose some revenue from the deferral of income tax, but this would be far more than offset by the additional revenue from imposing tax on more than 50 percent of benefits and from lowering or eliminating tax thresholds.

The dollar amounts involved can be gauged by reference to the tax expenditure tables prepared by Treasury and the Joint Committee on Taxation. The current revenue gain from full taxation of OASDI benefits is estimated at $16.8 billion. This represents, specifically, the difference between what is collected under current law from partial taxation of benefits above the threshold amounts and full taxation of all benefits above past employee payroll tax contributions. The dollar

amount of this potential additional revenue would diminish in the future because the thresholds for taxing benefits under current law are fixed and will protect an ever diminishing proportion of income from tax. The difference between what will be realized under current law and under full taxation as defined above would diminish also. Nevertheless, the amounts would be quite substantial for many years, making a sizable contribution to the trust funds—and to deficit reduction too under our present accounting rules.

Modest- to middle-income beneficiaries would see some reduction in their net benefits if the income tax thresholds were removed entirely. However, assuming other allowances—the personal exemption and standard deduction which were liberalized considerably by the Tax Reform Act of 1986—keep pace with inflation, the additional tax burden would be quite modest at the low end. Alternatively, the thresholds for social security taxation could be continued, but at a lower level to assure net revenue gains.

After 2000

The single most worrisome factor in the future of social security is also the most certain—the decline in the number of covered workers per OASDI beneficiary. Actually this ratio has been going down for years reflecting the maturing of the system. But as the babyboomers start retiring en masse after 2010, it will plunge from 3.3 in 1986 to 2.0 or below by the middle of the century. Because the major element in this relationship over the next 60-70 years is the number of workers and future workers already born, the real question is not whether, but how much, the ratio will decline. And this is the nub of the long-term problem with an income transfer program—simply not enough workers to support their elders in the style they have become accustomed to.

It should be emphasized that we would be facing this problem even if our birth rates were not skewed by events of the Great Depression and World War II. The aging of an intergenerational income transfer program almost inevitably would involve diminishing returns for future generations. This is why the social insurance system has often been characterized as a giant "Ponzi" game. The only way to avoid diminishing returns would be sustaining an extraordinarily high rate of productivity in the economy so that the growth of resources would offset both the natural maturing process of the system and the special demographic circumstances facing us in the next century. This is not a reasonable expectation.

An actual deficit in overall trust fund operations is not expected before the year 2000 unless the worst case of the Social Security Trustees develops. Under the middle range II-B assumptions, operating deficits would assume large proportions by 2020, well over $300 billion per year. Technically the funds still would not run out of money for many years after operating deficits began because of the accumulated assets in their accounts. But because these assets exist on paper only, the real crisis point would arrive along with the operating deficits. This is when real resources would have to be directed back from general government to pay the bills and when even more painful public policy choices would have to be made.

By mid-century the operating deficits under any scenario other than the most optimistic (and discredited) Alternative I of the Social Security Trustees become overwhelming—in the trillions of dollars. This is what provokes the spectre of payroll tax rates of 30-40 percent, or even higher, to support the existing schedule of benefits—a condition that no politician could tolerate. Obviously, should we proceed along such a track the system would break down before such confiscatory tax rates could be imposed.

Current Political Problem

It's tempting to try to ignore possible events of 20-50 years ahead. But regardless of the 21st century trends, we are faced with a much more current political problem now—the growing realization among younger workers that they cannot and will not realize anything near the returns from social security enjoyed by their elders. Peter Ferrara, an attorney who has written extensively about social security issues, calculates that the real rate of return on employee and employer contributions for young workers now entering the labor force and who remain single ranges from -1.0 percent for those at the maximum creditable wage to 2.13 percent for the low-income worker at the minimum wage. One-earner couples would get somewhat higher rates of return ranging from 1.3 percent to 3.75 percent. But according to Ferrara, in no case would social security returns approach what pension or thrift plan participants reasonably could expect from private sector programs or other market investments.[2] Furthermore, most steps that could be taken to reduce future benefits or raise taxes either for deficit reduction purposes or to correct long-term imbalances in OASDI programs are likely to depress these returns further.

Another way to look at it is to compare the present value of benefits and expected benefits less taxes paid by age group and the subsidy element in total benefit payments. Calculations by Michael J. Boskin for various age groups as of 1984 posed the following:

Table II
The Age Structure of Transfers under OASDI

Age (In 1984)	Present Value of Benefits and Expected Benefits less Taxes (average per family)	Transfers as Percentage of Total Benefits
72+	$69,000	89%
62 - 71	45,000	64
52 - 61	36,000	45
42 - 51	31,000	32
32- -41	21,200	18
under 32	16,000	17

Source: Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security*, ©1986 The Twentieth Century Fund, New York

[2] Peter Ferrara, *Social Security Rates of Returns for Today's Young Workers* (National Chamber Foundation, 1986).

According to Boskin's calculations, the transfer element or subsidy in social security benefits is still very high for elderly retirees and quite substantial for those at or near retirement, but it shrinks dramatically for younger workers. For some, the present value of benefits less taxes paid may become negative.

Social security system supporters say such comparisons are misleading. They claim that the inflation indexing feature of social security, even if it were compromised to some extent by adjustments such as the CPI-minus-two, produces a more assured income maintenance than can be obtained usually in the private sector, and that the important protections of insurance and disability coverage under OASDI are not reflected. Nevertheless, most all observers would agree that the gravy days of social security are coming to an end. Future retirees will "pay" for a larger and larger share of their eventual benefits and the transfer element or windfall to today's retirees will continue to shrink and eventually disappear.

Funding and Privatization

The idea of a funded, private sector alternative to social security has long held appeal for conservative critics. It had some success in development of IRAs and similar instruments which build retirement security while contributing to capital formation needs of the economy. *Replacing* social security with a private sector insurance plan, however, has never been able to overcome formidable doubts and obstacles.

- *Unfunded liabilities.* What to do with the trillions of unfunded liabilities of the present system? If a comprehensive funded program were started, participants might have to continue to support present retirees through payroll taxes while making contributions to their own retirement fund, doubling up the burden on the same generation.
- *The "cream skimming" argument.* How to reconcile the virtually universal coverage of social security with the risk averse practice of private insurance? And, could any sort of compulsory private sector plan covering the same broad population as social security offer the same type of returns that more limited market investments would?
- *Political poison.* So far every mention of "privatizing" social security has driven at least nine-tenths of the politicians the other way.

Two-Tier Approach

Michael J. Boskin has proposed a comprehensive two-tier social security financing mechanism. The first tier would be a means-tested income benefit for the low-income elderly and/or disabled. This would be akin to the existing Supplemental Security Income program, but presumably would cover more of the elderly population. It would be openly acknowledged as a welfare program, competing with other government expenditures and should be financed with general revenues.

The second tier would continue to be financed by payroll taxes but would not involve transfers of income from the working population to retirees. Instead, all of this tier's benefits would be based solely on lifetime contributions, employer and employee, with the same actuarial rate of return to all beneficiaries. The transfer and annuity aspects of the present social security system would be separated cleanly.

Because the transfer element in the present system will be very substantial well into the next century, eliminating it just for those above average earnings should keep the system in surplus throughout, according to Boskin.[3] It probably also could "pay" for an expanded SSI program, although Boskin does not make that explicit.

Obviously, the two-tier proposal would mean lower benefits for middle- and upper-income retirees compared to those expected under the present system for some years. Although current retirees would not be affected, those retiring in the near future would get a sharp jolt in benefit reduction if the new program were implemented without a phase-in or other adjustment. Boskin does not appear to pay much attention to the implementation problem. He does indicate that the second tier beneficiaries should appreciate the more certain rates of return under a strict annuity program treating all future beneficiaries the same in actuarial terms. Thus, regardless of their retirement date or family status, they would get the same rate of return. Uniform treatment also would simplify retirement planning for both employers and employees. Those at the low end of the earnings spectrum would "lose" the most in the second tier benefits under this system, but would be protected by the means-tested tier one plan and presumably, therefore, would not be adversely affected on a net basis. The two-tier approach separating welfare from annuity elements also has been endorsed by the American Institute of Certified Public Accountants (AICPA). The accountants go on to recommend full income taxation of benefits paid but with a full deduction of OASI taxes paid by the employee against their income taxes. A phase-in period on full benefit taxation would be allowed to account for the nondeductible portion of previous payroll tax contributions.[4]

Conclusions

Most people sense that social security is in some trouble—that promises made to the system's participants over the years will be very difficult to keep in the future. While substantial surpluses in the old age and disability funds are accumulating now, these will not last indefinitely.

There is great resistance to making any restrictive changes in social security benefits or in the financing structure. Partly this is due to the political muscle of the beneficiaries. The very

[3] Michael J. Boskin, op. cit.

[4] American Institute of Certified Public Accountants, *Suggested Improvements for Social Security Retirement System* (1987).

size of the social security system in relation to the Federal budget and its rapid growth as an entitlement income transfer also make radical changes improbable. Nevertheless, corrective measures certainly are needed and some are possible. The fact that the worst troubles are far off does not diminish the need for taking action now.

A significant near-term objective is to reduce the Federal budget deficit and raise the overall savings rate. This could be addressed by limiting the *increase* in social security benefits such as through the CPI-minus-two adjustment on inflation indexing. This particular proposal, if applied to both entitlement program outlays and the personal income tax structure, would mean substantial savings in expenditures and increases in revenue. It also would prolong the build-up of surpluses in the social security trust funds.

Some have argued that the social security system has not caused the budget deficit and that it would be unfair to cut benefits or not increase them as much as scheduled for lower income retirees. Because social security operates as a transfer program without any funded reserve, it really does not matter in economic terms whether or not it helped produce the present deficit. Any savings on benefits or increases in payroll or associated income taxes automatically would help alleviate the Federal government's overall financing problem and its call on the credit markets.

The fairness issue is more complicated. Social security benefits were liberalized considerably in the 1970s and the carryover of that has raised replacement rates—the ratio of benefits to previous earnings—for all beneficiaries. There is a very substantial transfer element—the payment of benefits above previous employer-employee contributions plus interest—going to all sectors but particularly at the lower income end. Across-the-board restraint, such as would be imposed by CPI-minus-two, could have an adverse effect on the real benefits of low- and middle-income retirees over a sustained period. If it were imposed only for a five year period, however, it would not appear to be that much of a burden for any income sector given the existing pattern of replacement rates and returns on past contributions.

There are proposals to raise or even eliminate the cap on the payroll tax wage base, or simply cut benefits to middle- and upper-income retirees. These are certain to arouse substantial opposition.

However, it may well be possible to reorient the benefit structure and *gradually* eliminate the transfer or subsidy element. This could be done through a two-tier system recommended by Professor Michael Boskin and by the AICPA. The annuity tier would continue to be financed by payroll tax contributions while the income support base logically would be financed by general revenues. The program would reduce benefits to middle- and upper-income retirees but would offer more certainty and equity among the participants, encouraging them to rely more on supplemental private retirement plans. Most important, it would put social security on a far sounder fiscal footing.

From a tax policy viewpoint, the AICPA proposal to subject OASI benefits to full income taxation with an accompanying deduction for OASI payroll taxes makes sense. It would rationalize the tax treatment of social security along the same lines as private pensions, IRAs and Keogh plans. It would lessen the present transfer of income between generations and make younger workers more willing to support the system. A problem, of course, would be the current revenue cost of the payroll tax deduction, but this could be largely offset by subjecting benefits to full income taxation with necessary adjustment to prevent double taxation. The deduction could be phased in, starting perhaps at 50 percent, the same as planned under current law for the self-employed. Then to complete the cycle, retirees would pay tax on all benefits received *after* recovering their own payroll tax contributions for which no deduction had been taken.

Some will object to a cost recovery rule that produces a lower effective rate of tax in the early retirement years and a higher rate later on. The alternative is to use a formula based on life expectancy to prorate the cost recovery as now is done for contributory pension plans.

A solution to the problems of financing social insurance with the best chance of success will involve changes in both the benefits structure and tax policy. The concept of a publicly financed retirement/disability system would be retained but middle- and upper-income retirees would be encouraged to rely more on private sector arrangements in keeping with the original intent of social security. Future rates of return will be lower for most participants. But this will happen anyway given the financial strains on the system. The larger question is whether or not necessary reforms can be implemented in a reasonable and equitable manner to take the pressure off social security. If not, the system could fall apart in class and generational warfare.

This article is drawn mainly from a Tax Foundation working paper of the same title dated March 15, 1988, but incorporates new data from the 1988 Annual Report of the OASDI Board of Trustees, dated May 5, 1988.

(TYPICAL FAMILY, *from page 1*)

Federal taxes and inflation.

Federal Taxes

Since 1980, Federal income tax on this family has risen 38.8 percent despite two major income tax reduction laws in 1981 and 1986. The bite that Social Security taxes take out of this family's income has increased rapidly, jumping 93.7 percent from $1,816 in 1980 to $3,518 by 1988. Social Security will claim 7.5 percent of this family's 1988 earnings, up from 6.1 percent in 1980. Direct Federal taxes will take 19.5 percent of this family's 1988 income, down slightly from the 1981 peak that claimed 20.3 percent.

Inflation

The most significant reason for the increase in this family's purchasing power since 1980 is the leveling off of inflation. Inflation had increases an averaged 8.9 percent from 1973-1980 and stood at 13.5 percent in 1980. It has averaged a 4.6 percent annual rate since 1981, while the two-earner family's income has grown by an average of 5.9 percent for the same period.

The sizeable 58 percent nominal income gain the two-earner family has made since 1980 has been reduced to only a 10.9 percent gain after direct Federal taxes and inflation are taken into account. Other indirect Federal taxes and state and local tax increases not shown here have further offset the family's increased earnings. However, measured in constant 1988 dollars, the two-earner family managed to obtain an average 1.3 percent yearly increase in real income, after direct Federal taxes, between 1980 and 1988.

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THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"A State-Managed Industrial Sector"

The 100th Congress has come within a whisker of Europeanizing American industry, saved from its foolishness only by a greatly deserved Presidential veto. The step toward European-style socialism was, of course, the plant closings notification issue grafted onto the trade-bill to make the provision, Congress hoped, veto proof.

As is typical, fairness was the rubric under which the anti-business forces on the Hill mustered the troops. After all, isn't it only reasonable to demand that employers announce closing sufficiently long in advance to enable those affected by the shut-down to make other plans? How easy it is to cloak market-stifling social and economic policy in motherhood-and-apple pie rhetoric.

What the notifications proviso really does, of course, is to attack the market system at its very heart—that the free and open competition for economic resources be dictated by supply and demand. On the front end, it means that companies cannot close superfluous or inefficient plants in response to market conditions. This short-term attempt to prolong the current jobs of employees will have long-term harmful effects on them, their communities and future generations of workers.

Companies will find they cannot quickly shut down operations deemed unnecessary in a given part of the business cycle. Compliance will require a level of accuracy in forecasting that would test the clairvoyant skills of a gypsy fortune teller. Early advance notice will quickly drain companies of talented, motivated and younger workers — traditonally those in greater demand on labor markets — leaving firms at the mercy of workers with less potential for reemployment. Local governments would be given a role in "monitoring" compliance tantamount to putting the fox in charge of the hen coop.

Businessman will cope. They will soon learn that the answer is to be extremely cautious about reopening plants or building new ones during economic rebounds.

What this will do, as has been noted above, is Europeanize American industry. Because any new jobs created will have to be sustained even when market forces dictate otherwise, firms will hold back on creating new jobs. We will have the flat, static employment patterns of Europe, with great numbers of permanently unemployed or underemployed individuals. We will have erosion of the innovation and risk-taking that characterize a vital business sector, as social policy dictates that businessmen continue to keep open factories that are no longer justified by sales forecasts.

Besides squelching the enterpreneurial spirit, advance closing notice will fail to serve the long-term interests of the labor market by drastically slowing the creation of jobs. It will hinder economic growth by increasing the "notch" to be reached before a venture becomes worth pursuing. And it will reduce corporate tax revenues which closely track the levels of job creation and industrial capacity levels.

Addendum: *"The Competitive Burden: Tax Treatment of U.S. Multinationals"* has turned into a Foundation best seller. An interesting sidelight: Representatives of foreign governments in Washington have ordered numerous copies.

(TAX BURDEN, *from page 1*)
top ten percent paid $20,248, 77 percent more than they paid in 1979. While the top 10 percent, or 10.3 million earners, paid well over half the total income tax in 1986, their adjusted gross income ranged down to $48,980, which is not exactly "fat cat" status. It still takes millions of basically middle and upper-middle income taxpayers to pay the bulk of the total income tax bill.

The average tax rate in 1986 ranged from 3.4 percent for the lowest 25 percent to a high of 26.3 percent for the top five percent, indicating the broad progression of the system. Tax data exemplifies that the across-the-board tax rate reductions established by ERTA in 1981 fostered a sharp increase in the tax share paid by upper income individuals. Further changes under the Tax Reform Act of 1986 should make the overall system a little more progressive, particularly by removing approximately six million low-income earners from the rolls.

Figure I

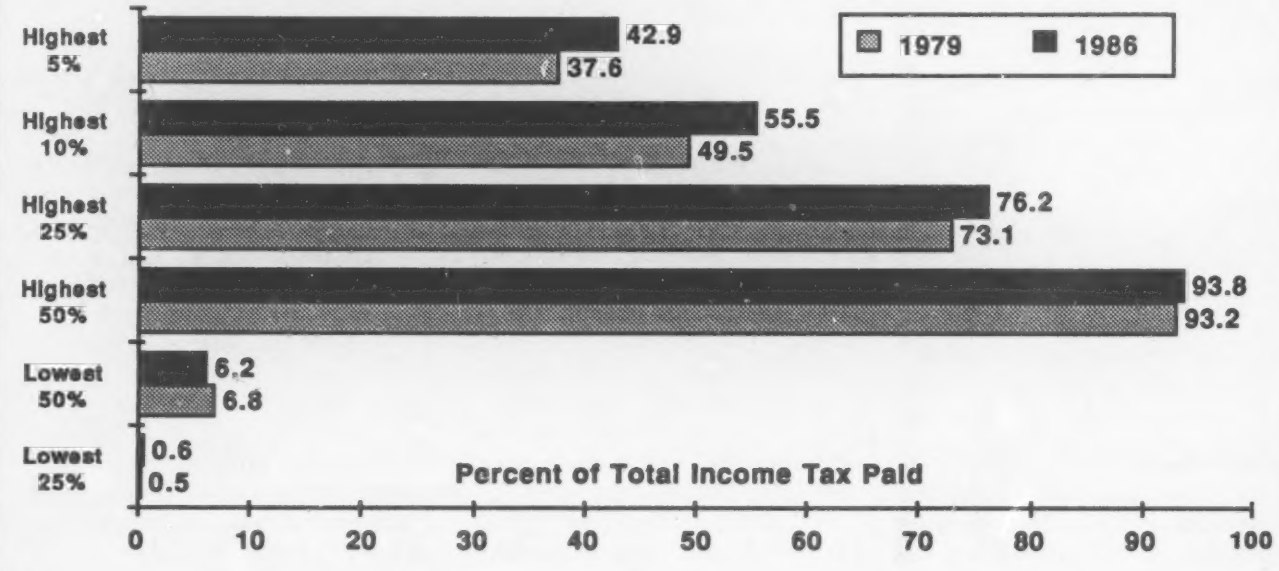

Table I

Federal Income Taxes Paid by High and Low-Income Taxpayers, 1979 and 1986[a]

Adjusted Gross Income Class	Income Level		Percent of Tax Paid		Average Tax	
	1979	1986	1979	1986	1979	1986
Highest 5%	$ 39,900 or more	$ 67,000 or more	37.6%	42.9%	$ 17,407	$ 31,309
Highest 10%	32,710 or more	48,980 or more	49.5	55.5	11,456	20,248
Highest 25%	21,760 or more	32,420 or more	73.1	76.2	6,769	11,132
Highest 50%	11,870 or more	17,148 or more	93.2	93.8	4,315	6,845
Lowest 50%	11,869 or less	17,147 or less	6.8	6.2	313	455
Lowest 25%	5,565 or less	7,806 or less	0.5	0.6	46	90
Lowest 10%	2,212 or less	3,123 or less	[b]	[b]	9	27

1986 Income and Tax Data

Adjusted Gross Income Class	Total Individual Returns (thousands)	Total Adjusted Gross Income ($billions)	Percentage of Adjusted Gross Income	Average Tax Rate
Highest 5%	5,165	$ 613.7	24.3%	26.3%
Highest 10%	10,330	909.2	36.0	23.0
Highest 25%	25,825	1,512.7	60.0	19.0
Highest 50%	51,650	2,139.6	84.8	16.5
Lowest 50%	51,650	383.0	15.2	6.1
Lowest 25%	25,825	68.0	2.7	3.4
Lowest 10%	10,330	-16.2	—	—

[a] Data for 1986 are preliminary.
[b] Less than .07 percent.
Source: Tax Foundation computations based on Statistics of Income, Internal Revenue Service, U.S. Department of the Treasury.

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* Total government tax revenues per person were up 131 percent from $2,063 in 1976 to an estimated $4,774 in 1986. The Federal government collected $3,131 in tax revenue per person, state government $1,039, and local government $604.

* The 1986 Tax Index for all taxes was at 561.6 (1967=100). The biggest tax increases as measured by the tax index has occurred in social insurance contributions at 828.4 (1967=100).

* Estimated Federal, state, and local debt increased 15.4 percent in 1986, reaching $2,765,070 million, a 217 percent increase from 1976.

* Of the 23 nations belonging to the Organisation for Economic Cooperation and Development (OECD), the U.S. ranked 20th in tax revenues as a percentage of GDP in 1985 with 29.2 percent. At the high end were Sweden (50.5 percent), and Denmark (49.2 percent). At the low end were Japan (28 percent) and Turkey at 16.1 percent of GDP.

* In 1987 there were 98.5 million households, up 1.1 percent from 1986, with each household averaging 2.66 persons.

* In 1986 17.8 percent of the U.S. population was 25-34 years of age, numbering 42.8 million. By the year 2030, 21.2 percent of the population will be 65 and older, numbering 64.6 million.

* Connecticut had the highest per capita personal income in 1986 at $19,600 — the lowest was Mississippi at $9,716.

* The personal savings rate fell from 7.6 percent in 1976 to only 4.3 percent in 1986.

* Estimated Federal tax collections increased ten percent from 1986 to 1987 and are projected to rise 9.2 percent in fiscal year 1988.

* The average salary of a full-time Federal civilian employee was $27,375 in 1987.

* Of the 49 largest cities in 1985, Washington, D.C., had the highest per capita general expenditures at $4,551 — the lowest was El Paso at $391.

Facts and Figures belongs on the reference shelf of every person interested in public finance.

(GRANTS-IN-AID, *from page 2*)

tax costs for grants, 18 states were net "losers" in 1987; i.e., their aggregate Federal tax burden to support grant programs exceeded the amount of grants received by their respective state and local governments. As a whole, the 124 million residents of these "paying" states paid $56 billion in Federal taxes to support such programs while their state and local governments received $45.8 billion in grants — an average Federal tax burden of $1.22 for each dollar of grants received. In the "winners" column were the other 32 states and the District of Columbia, who paid an average of 82 cents in Federal taxes per dollar of aid. These 32 states and D.C. received $57.1 billion in Federal grants while paying only $46.9 billion to the Federal government in order to support these grant programs.

For the second year in a row, residents of Florida paid the highest tax premium per dollar of Federal aid. Floridians paid $1.60 in taxes per dollar of aid, up from $1.50 in FY86. Other states with high tax premiums were Texas ($1.41), New Jersey ($1.37), Connecticut ($1.36), New Hampshire ($1.30), and Colorado ($1.27).

Among the "receiving states," residents of the nation's capital got the best bargain, paying 36 cents per dollar of Federal aid. Other jurisdictions at the low-cost end include Alaska (49 cents), South Dakota (50 cents), Mississippi (53 cents), and Montana and West Virginia at 54 cents.

Tax Foundation's methodology for deriving the Federal tax burdens borne by residents of each state is designed to show where the tax dollars actually originate rather than where they were collected. Grants-in-aid are based on data reported by the Bureau of the Census, with adjustments made for shared revenues and data for outlying territories.

Many Federal grant programs require that the state and local recipients match Federal funds with their own. Tax Foundation economists estimate that state and local governments were required to provide 41 cents for every dollar they received in Federal grants, up from the 37 cents needed in 1980. State and local governments raised an estimated $42.2 billion to match the $102.9 billion received in 1987. Total Federal, state and local costs of the grants programs were $145.1 billion for FY87.

Tax Foundation analysts point out that these comparisons of Federal tax burdens for aid assistance do not reflect the entire cost to state and local governments of obtaining grants. In addition to the estimated $42.2 billion these jurisdictions had to raise to match Federal payments, there are additional costs associated with administering the federal grants programs.

The table on page two provides state-by-state data on Federal grants as compared to Federal tax costs in Fiscal Year 1987. Further details are provided in the "Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1987," available from the Tax Foundation for $4.00 plus $1.00 postage and handling.

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